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CITATIONS

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In the Supreme Court of the United States

OCTOBER TERM, 1945

No. 149

NEVILLE COKE & CHEMICAL COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court of The United States (R. 3a–12a) is reported in 3 T. C. 113. The opinion of the Circuit Court of Appeals (R. 174–181) is reported in 148 F. 2d 599.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on March 22, 1945 (R. 181). The petition for a writ of certiorari was filed on June 21, 1945. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether, under Section 112 (b) (3) of the Revenue Act of 1936, the gain on a transfer by the taxpayer of short term notes, some of which were past due, in exchange for debentures and stock, pursuant to a plan of reorganization of taxpayer's debtor under Section 77B of the Bankruptcy Act, should be recognized.

The answer to this question depends on whether the notes are "securities" within the meaning of Section 112 (b) (3).

STATUTES AND TREASURY DECISION INVOLVED

The statutes and treasury decision involved are set out in the Appendix, *infra,* pp. 14–17.

STATEMENT

The pertinent facts as stipulated (R. 13a–23a) and as found by the Tax Court (R. 3a–8a) are as follows:

Prior to 1932, the Davison Coke & Iron Company[1] (hereinafter referred to as the "debtor" company) became largely indebted to two companies known as the Hillman Coal & Coke Company (hereinafter referred to as the Hillman Company) and the W. J. Rainey, Inc. (hereinafter referred to as the Rainey Company), for coal sold by those companies on credit, and for certain promissory notes of the debtor company

[1] In 1936 the corporate name was changed to Pittsburgh Coke & Iron Company (R. 4a, 14a).

which the Hillman Company had discounted. In 1932 the debtor company, although solvent, was unable to meet its current financial obligations and it therefore entered into a reorganization plan and agreement with its principal creditors. (R. 15a.) Among other things, the plan provided that the date for payment of the indebtedness be extended (R. 4a, 14a–15a), and that certain notes for terms of three, four and five years be accepted by creditors (R. 92a).

On June 8, 1933, the Hillman Company and the Rainey Company caused the taxpayer to be formed under the laws of the State of Delaware (R. 15a) in order to center in it the ownership of their interests in, and the indebtedness due from, the debtor company (R. 4a, 15a). They thereupon transferred to the taxpayer the following assets (R. 16a):

	Face amount or number of shares	Cost to transferors
Preferred accounts receivable due from Davison Coke & Iron Company	$67,884.60	$67,884.60
First Mortgage bonds of Davison Coke & Iron Company	500,000.00	450,000.00
Accounts receivable (not preferred) due from Davison Coke & Iron Company)	86,550.00	86,550.00
Notes of Davison Coke & Iron Company due in three, four and five years	1,129,000.00	1,129,000.00
Stock of Davison Coke & Iron Company Prior Preferred	15,094 shs.	0
Preferred	2,500 shs.	250,000.00
Common	14,701 shs.	8,622.18
		1,992,056.78

As consideration for these assets the taxpayer gave the following (R. 17a):

	To Hillman Coal & Coke Co.	To W. J. Rainey, Inc.	Total
Preferred Stock of Petitioner	21,264 shs.	13,726 shs.	34,990 shs.
Common Stock of Petitioner	16,640 shs.	25,060 shs.	41,700 shs.
Notes due in five years	$14,908.11	$52,976.49	$67,884.60

The above stock and notes were issued to the Hillman and Rainey Companies in proportion to the assets transferred to the taxpayer. The preferred and common stock of taxpayer had equal voting rights: Immediately after the transfer, the transferors owned all of the outstanding capital stock of the taxpayer. (R. 6a, 17a.)

On October 31, 1935, the debtor company filed a petition in bankruptcy, under the provisions of Section 77B of the Bankruptcy Act, to effect a plan of reorganization. On January 31, 1936, the District Court entered its final decree in the proceedings, witnessing the fact that the plan had been fully and completely executed and consummated. (R. 6a, 17a.) The reorganization plan involved an exchange of preferred and common stock for new stock, the exchange of bonds for debentures, and various adjustments of creditors' rights (R. 137a–145a).

One of the readjustments[2] effected under the plan of reorganization was the surrender by the taxpayer of the unsecured three-, four- and five-

[2] As a part of the reorganization, the taxpayer also exchanged bonds, stock, and accounts receivable for new debentures, common stock, notes, and cash. The tax consequences of these exchanges are not in issue.

year notes, issued on April 1, 1932, without interest, in the face amount of $1,129,000, in exchange for new interest bearing debentures of the same face amount, plus 22,580 shares of new common stock of the debtor company (R. 6a–7a, 18a–19a).[3]

The taxpayer contended that the gain[4] realized upon the exchange of the notes for the new debentures and stock was a non-recognized gain within the purview of Section 112 (b) (3) of the Revenue Act of 1936. The Tax Court sustained the Commissioner's determination that the notes were not "securities" within the meaning of that Section and that the gain was therefore taxable. (R. 8a, 9a.) The Circuit Court of Appeals affirmed (R. 181).

ARGUMENT

Subsection (b) of Section 112 of the Revenue Act of 1936 (Appendix, *infra*, pp. 14–15) lists all

[3] Of the $1,129,000 in notes, $500,000 were three year notes, $250,000 were four year notes and $250,000 were five year notes, all having been received by the Hillman Company in 1932 in exchange for $500,000 demand notes and $500,000 past due promissory notes (R. 92a). The remaining $129,000 represented three-year notes received by the Hillman Company and the Rainey Company in 1932 as current creditors of the debtor corporation (R. 98a–99a), apparently for merchandise sold that company.

[4] There is here no dispute as to the Tax Court's findings (R. 8a) that the new debentures had a fair market value, on the date of acquisition, equal to their face value, and that the new common stock received had a value on that date of $5 per share.

of the exchange transactions in which gain or loss is not recognized and is entitled "Exchanges Solely in Kind." The particular provision under which the taxpayer claims that its exchange of unsecured, short-term notes of its debtor for new debentures and stock is a nontaxable transaction is Section 112 (b) (3), relating to an exchange of stock or securities in a corporation a party to a reorganization, in pursuance of the plan of reorganization, solely for stock or securities in such corporation.

The Tax Court and the court below agreed that there was a recapitalization and, hence, a reorganization within the meaning of Section 112 (g) of the Act (R. 8a, 175–176), but held that the notes here involved were not securities within the meaning of Section 112 (b) (3). The basis of the holding of the court below was that the notes did not represent a "proprietary interest" in the debtor corporation which underwent a recapitalization (R. 177–178.) It is not wholly clear, however, that the court below used the term "proprietary interest" in the sense of a stockholder's interest (R. 178), since the Government had not contended that the term "securities" as used in Section 112 (b) (3) referred only to stock. Nor is that construction of the statute necessary to sustain the decision. It is sufficient if, as the Government contended below, the term "securities" does not include unsecured, temporary evidences of indebtedness which form no part of the capital structure of the corporation.

In *Le Tulle* v. *Scofield,* 308 U. S. 415, this Court held that a corporation's exchange of assets for bonds and cash was not a nontaxable reorganization within the meaning of Section 112 (b) (4) and (i) (1) (A) of the Revenue Act of 1928, c. 852, 45 Stat. 791, for the reason that the bonds, regardless of their term, did not give to the transferor any proprietary interest in the corporation. It is true, as petitioner suggests, that the Court did not hold that the bonds there involved were not "securities" within the meaning of Section 112 (b) (4), but neither did the Court say or imply that all evidences of indebtedness are securities. It is true also that the Court cited *Helvering* v. *Watts,* 296 U. S. 387, holding that there is a reorganization where the stockholders of a corporation exchange their stock for a substantial proportion of stock of another corporation in addition to mortgage bonds and, further, that the total consideration received (stock and bonds) is exempt from tax, since both bonds and stock were "securities" within the meaning of Section 203 (b) (2) of the Revenue Act of 1924, c. 234, 43 Stat. 364, and not "other property," within the meaning of Section 203 (e). If, therefore, the Court, in the *Le Tulle* case, approved the *Watts* decision and thus implied that the term "securities" within the meaning of Section 112 (b) (3) and (4) of the 1936 Act or corresponding provisions of the earlier Acts includes mortgage

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bonds such as were involved in the *Watts* case, at least where a substantial block of stock is also acquired, the very manner in which that decision is summarized indicates that the term "securities" does not include all evidences of indebtedness of whatever character. This conclusion is fortified by the Court's reference, with apparent approval, to its decision in *Pinellas Ice Co.* v. *Commissioner,* 287 U. S. 462, where the Court held not only that a transfer of assets for cash and short-term notes was a sale, not a reorganization, but further, that the notes were not "securities." Unless the *Le Tulle* case must be accepted as overruling the decision in the *Watts* case, and as meaning that not even mortgage bonds are to be regarded as securities, within the meaning of Section 112 (b) (4)—an assumption which seems unjustified (see *Lloyd-Smith* v. *Commissioner,* 116 F. 2d 642 (C. C. A. 2d), certiorari denied, 313 U. S. 588) and one which in no way aids the petitioner—then the decision must be accepted as strengthening, or at least leaving unchanged, the rule previously recognized by this Court and other courts that only secured and/or long-term obligations forming a part of the capital structure of the corporation are "securities" within the meaning of Section 112 (b), whereas unsecured short-term obligations are not (see *Lloyd-Smith* v. *Commissioner, supra*).

The reasoning of the court in this case and in *Burnham* v. *Commissioner,* 86 F. 2d 776 (C. C. A. 7th), certiorari denied, 300 U. S. 683, is in conflict

only if the court below actually held that shares of stock alone are securities. In any event, the *Burnham* case is distinguishable on its facts and is not in direct conflict with this case. The *Burnham* decision itself recognized that whether notes were securities depended on all the circumstances of the case (86 F. 2d at 777), and the court's conclusion was based primarily on the ground that the notes exchanged for stock were for a long term, that is, for ten years, only two years of which had expired.[5] Of the total amount of the notes here involved, all issued in April, 1932, $629,000 was due in three years, $250,000 in four years, and $250,000 in five years from that date (R. 92a, 98a–99a, 178). The bulk of them were thus past due at the time of the exchange in 1936, and the remainder had from a few months to less than a year and a half to run. Thus, the notes, when issued, represented not an attempt at permanent financing but, on the contrary, merely a temporary adjustment of indebtedness, and, when the exchange occurred, they were obviously not a part of the capital structure of the corporation.

In any event, since the *Le Tulle* decision the courts have generally held that unsecured promissory notes (particularly those for a short period)

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[5] In *Le Tulle* v. *Scofield*, 308 U. S. 415, 420, fn. 7, this Court cited the *Burnham* case, among others, as an instance of the difficulty that had developed in classifying securities in various cases.

are not securities within the meaning of the reorganization provision. *F. T. Bedford* v. *Commissioner,* decided July 12, 1945 (C. C. A. 2d); *Commissioner* v. *Sisto F. Corp.,* 139 F. 2d 253 (C. C. A. 2d); *Lloyd-Smith* v. *Commissioner, supra; Commissioner* v. *Segall,* 114 F. 2d 706 (C. C. A. 6th), certiorari denied, 313 U. S. 562. See also, *Hoagland Corp.* v. *Helvering,* 121 F. 2d 962, 964, in which the Second Circuit Court of Appeals rendered no decision on this point but merely held that whether or not Section 112 (b) (3) applied, the claimed loss was not deductible.[6] On the other hand, in *Commissioner* v. *Neustadt's*

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[6] The taxpayer's assertion (Br. 23–24) that in his brief in that case the Commissioner relied primarily upon the *Burnham* decision is erroneous. The Government's brief carefully pointed out (pp. 9–10) that although the decision of the Board of Tax Appeals, holding that notes were securities, was supported by the *Burnham* decision, there were subsequent decisions of other circuit courts of appeals holding that unsecured promissory notes might not be treated as securities within the meaning of Section 112 (b) (3). After citing the cases referred to above in support of that statement, the Government concluded:

> Upon the basis of the decisions just cited it appears then that unsecured, promissory notes may not be treated as "securities" within the meaning of Section 112 (b) (3), *infra.*

The Commissioner relied, for affirmance, upon the fact that the taxpayer had failed to prove any basis by which gain or loss might be measured.

It is true, as pointed out by petitioner (Br. 14–15), that in the Government's brief in opposition in the *Burnham* case, No. 778, October Term, 1936, pp. 6–7, the Government took a contrary position as to the meaning of the term "securities." But that was prior to the decision in the *Le Tulle* case.

Trust, 131 F. 2d 528 (C. C. A. 2d), the court observed that in the common financial parlance of the business world, a long-term funded debt, represented by convertible debentures, was regarded as forming part of the capital structure of a corporation, and held that the twenty-year debentures there involved were securities.

The argument of the petitioner (Br. 15–18) that the court below has extended the scope of *Le Tulle* v. *Scofield,* 308 U. S. 415, and *Pinellas Ice Co.* v. *Commissioner,* 287 U. S. 462, is, we submit, without substance. As the court below pointed out (R. 176–177), the phrase "stock or securities" is used twice in Section 112 (b) (3), once to refer to what is given up and once to refer to what is received. There is nothing in the subdivision to suggest that the two identical phrases have a different meaning. Cf. *Lloyd-Smith* v. *Commissioner, supra.* And in *F. T. Bedford* v. *Commissioner, supra,* the Second Circuit agreed with the holding of the court below that the word "securities" has a consistent meaning throughout Section 112 (b) (3).

Nor is the decision below contrary to the holding of this Court in *Helvering* v. *Limestone Co.,* 315 U. S. 179. Based primarily upon the fact that the three, four and five year notes, which the taxpayer acquired as assignee of the creditors, at no time gave the taxpayer a right of control over the debtor company, the ruling in this case is in

harmony with the *Limestone* decision. In the *Limestone* case, the Court, in deciding whether the physical properties exchanged had the same basis in the hands of the transferee as they had in the hands of the transferor, merely held that a reorganization occurred where the noteholders, by reason of the insolvency of their corporation, had acquired a proprietary interest in the corporation. Here the fact that the noteholders had not succeeded to the rights of stockholders is evidenced by the fact that the stockholders acquired new stock in the company in exchange for existing shares. The noteholders in the instant case received a markedly different kind of interest from that which they held, and there was not an exchange "solely in kind" such as Section 112 (b) was designed to exempt.

Taxpayer contends (Br. 22) that the question presented has become more important because of the addition made by Section 121 of the Revenue Act of 1943 (Appendix, *infra,* pp. 15–16), of subdivision (b) (10) and (*l*) to Section 112 of the Internal Revenue Code. But these subsections are inapplicable to the type of proceeding here involved and are of limited application. Section 112*l* (1), which uses the phrase "stock or securities," applies only to the type of proceeding referred to in subsection (b) (10), *i. e.,* to those cases in which the property of the old corporation is transferred to a different corporation or, in the

words of the statute, "to another corporation organized or made use of to effectuate" the court-approved plan of reorganization. See the unreported supplemental memorandum opinion of the Tax Court, April 17, 1944, in *Bedford* v. *Commissioner* (1944 P–H T. C. Memorandum Decisions Service, par. 44,123), affirmed on July 12, 1945, by the Circuit Court of Appeals for the Second Circuit, and T. D. 5402, 1944–18 Int. Rev. Bull. 3 (Appendix, *infra,* pp. 16–17). Construction of these statutes will necessarily require consideration in the particular cases in which they are involved, irrespective of the decision here.

CONCLUSION

The decison below is correct. There is no direct conflict and no question is presented which warrants review by this Court. The petition should be denied.

Respectfully submitted.

HUGH B. COX,
Acting Solicitor General.
SAMUEL O. CLARK, JR.,
Assistant Attorney General.
SEWALL KEY,
HELEN R. CARLOSS,
MURIEL S. PAUL,
Special Assistants to the Attorney General.

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